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In Principle

A Newsletter from Bingham's Financial Regulatory Practice

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Newsletter

IN THIS ISSUE

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BINGHAM'S UK FINANCIAL REGULATORY PRACTICE

Our team advises UK- and US-based clients on the UK financial services regulatory framework, including investigations and enforcement proceedings, with a particular focus on retail markets. The team also has an active advisory practice. Clients include both regulated institutions and regulators.

Working in collaboration with Bingham's premier global securities practice, we also provide counselling, regulatory compliance and defence services to broker-dealers, investment advisers, investment managers, investment banks, mutual funds, hedge funds and other private investment funds, accounting firms, insurance companies, public companies, and officers and directors.

From the Financial Regulatory Practice

Welcome to the latest edition of In Principle, our newsletter focusing on developments in UK financial services regulation.

2013 will be a year of significant change for those subject to financial services regulation in the UK. The new Financial Services Act received royal assent on 19 December 2012, and it is anticipated to become effective on 1 April 2013. We refer to it as the "**new Act**", but technically it is an act which amends the Financial Services and Markets Act 2000, the Bank of England Act 1998, and the Banking Act 2009, and so these acts will continue in law, albeit in heavily amended form. The new Act brings about a new structure for UK financial services regulation. The FSA will be replaced by the Financial Conduct Authority (the "**FCA**") and the Prudential Regulatory Authority (the "**PRA**"). All firms will be regulated for conduct of business by the FCA, and in this edition we focus in particular on how the authority will deliver its new, more intrusive and judgement-led approach to conduct regulation.

We consider the five elements which the FCA has said will characterise its new approach to more proactive and effective regulation. We look at the new powers which the authority will gain under the new Act and how they might be used to help it deliver that new approach.

Conduct regulation has historically been focused on retail conduct of business. However, the FCA has committed itself to a more intrusive approach to the regulation of conduct in wholesale markets and between wholesale market participants. We review what this might mean in practice for those operating in this area.

Our final article considers some of the major FSA enforcement cases from the past year. This has been a year in which the FSA has imposed record levels of fines and has sought to discipline a number of senior and high-profile individuals within the financial services community. The FSA has been prepared to take difficult cases and to run the risk of having its decisions overturned by the independent tribunal. The FSA's approach is a good indicator of how the FCA will seek to use its enforcement powers to achieve higher fines and secure greater amounts of customer redress to deliver credible deterrence under the new regime.

During this year of significant change, firms and individuals will need practical and effective advice when dealing with the new regulators. If you would like any more information about any aspect of the new regulatory structure or in relation to any current issue, please contact us.

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Transition to FCA and PRA

The transition of responsibility for the regulation of firms and markets from the Financial Services Authority ("**FSA**") to the Financial Conduct Authority ("**FCA**") and Prudential Regulatory Authority ("**PRA**") is a major step toward a new era for financial regulation. It will herald significant changes to the supervision of firms and in their relationship with regulators whose culture and approach is going to be very different to that of the FSA.

Prudential regulation (i.e. regulation to promote the safety and soundness of firms) for those firms which are viewed as having the greatest potential impact on the stability of the UK financial system will be undertaken by the PRA. Around 1,700 firms comprising deposit takers, insurers and a small number of major investment firms (which PRA will individually designate)[1] will be subject to prudential regulation by the PRA.

1 Investment firms will only be capable of designation if they deal in investments as principal and have, or if they are applying for permission would have, a minimum capital requirement of €730,000. PRA's draft policy states that it will apply a minimum assets threshold of £15 billion at firm or group level and will only designate an investment firm if it determines that the firm could pose significant risks to the stability of the financial system or to one or more PRA regulated entities within that firm's group.

Conduct regulation (i.e. regulation that is aimed at protecting consumers and the integrity of markets) will fall to the FCA. The FCA will have responsibility for conduct supervision for all firms (around 26,000), including those firms regulated by PRA for prudential purposes; for prudential supervision of those firms not prudentially supervised by the PRA (about 24,000); and for markets regulation.

The new structure will also bring a new approach to regulation from the PRA and the FCA. The industry and consumers are promised a shift toward "*judgement-led*" regulation, from what has now, with the benefit of hindsight, been criticised as "*narrow, rule based compliance*". The new regulators expect to place a strong emphasis on holding firms and individuals to account faster and more effectively and on acting earlier and more decisively. <

The FCA's Approach to Conduct Regulation

The new Act sets out the objectives which will drive the FCA's approach. The FCA's strategic objective is to ensure that relevant markets function well. This is underpinned by three operational objectives:

1. Securing an appropriate degree of protection for consumers (the consumer protection objective);
2. Protecting and enhancing the integrity of the UK financial system (the integrity objective); and
3. Promoting effective competition[1] in the interests of consumers in the market for financial services (the competition objective).

The FCA's approach to regulation will, it claims, be characterised by a commitment to intervene earlier to prevent harm to consumers and damage to the integrity of markets. The FCA expects this to be a significant change from the more traditional approach of dealing with risks after they have crystallised. To achieve its aims, the FCA will be heavily reliant on spotting emerging issues both at a firm-specific and sector-wide level. It has committed itself to developing enhanced data gathering and analysis capabilities to spot these issues before they become significant problems. The FCA will gather information from many sources including firms, customers, Financial Ombudsman Service, whistleblowers, consumer groups and other regulators to gain a wide understanding of what is really happening in the markets. Firms will need to adjust their own approaches to managing regulatory risk to ensure that they are fully aware of and are managing relevant emerging issues within their industry sector. They will need to keep abreast of the FCA's work so that they can avoid damage to their business from unforeseen action by the FCA.

The FCA will "*be looking for firms to base their business model, their culture, and how they run their business, on a foundation of fair treatment of customers as set out in the [FSA] Treating Customers Fairly initiative*". This focus on achieving a fair deal for the customer will be central to all of the FCA's thinking. The FCA will expect firms to be committed to fair customer treatment and market integrity and will expect firms to go beyond the letter and detail of the rules when carrying out their business. Firms, for

1 The competition objective applies to: (a) the markets for regulated financial services (which is defined widely in S1H of the new Act) and (b) the markets for services provided by recognised investment exchanges where they carry on regulated activities that are exempt from the general prohibition. Regarding competition, the matters to which the FCA is expected to have regard include: the needs of different consumers, including their need for information which enables them to make informed choices; the ease with which consumers can change their supplier of services; the ease of entry to the market for new participants; and the extent to which competition encourages intervention. S1E of the new Act.

The FCA's Approach to Conduct Regulation *continued from page 1*

their part, will need to ensure that they put the interests of consumers at the heart of their business; are considering (and can show that they are considering) the overall quality, appropriateness and value of the products and services that they are providing to their customers; are ensuring that their products are properly targeted; and are properly managing any incentives that may have the potential to work against a customer's interests.

The FCA expects to be far more interventionist than the FSA, not only in the retail markets where the FSA has historically focused much of its efforts, but also in the wholesale markets. The FCA has said it will go beyond accepting that the *caveat emptor* principle is the appropriate standard in all cases in the wholesale markets. The FCA considers that interaction between market counterparties can ultimately affect the interests of retail customers and that wholesale conduct can therefore be "*relevant to both our consumer protection and market integrity objectives*". The FCA considers that poor wholesale conduct includes not only criminal behaviour and market abuse but also extends to:

> "*a wide range of activities that exploit differences in expertise or market power to undermine trust in the integrity of markets or cause harm to retail consumers*".

The next article looks in more detail at the FCA's proposed approach to regulation of wholesale conduct. In this article, we look in more detail at the five elements that the FCA has said will deliver its new approach to conduct regulation.

1. To be more forward looking in its assessment of potential problems

The FCA will seek to identify potential issues before problems crystallise. This commitment will be seen in the FCA's approach to the authorisation and supervision of firms and in the allocation of the FCA's own internal resource.

At the authorisation stage, there will be a greater emphasis on how a firm will make money and whether its business model and strategy are consistent with delivering good outcomes for customers and whether they present a risk to the integrity of the market.

The new Act introduces new threshold conditions, including a new "Business Model" threshold condition[2]. Threshold conditions have to be met by firms on application for authorisation and then on a continuous basis. The new condition requires a firm's business model to be "suitable", and the FCA has consulted on proposed guidance[3] so that firms can understand what they need to do to comply with the condition. The proposed guidance gives a non-exhaustive list of issues that will be considered by FCA. The FCA will require a firm to show it has an "*appropriate, viable and sustainable business model, given the nature and scale of business that it intends to carry out*[4]". The FCA will, amongst other things, take the following matters into account in deciding whether a firm's business model is suitable:

(1) The assumptions behind the Business Model;

(2) The rationale for the business and how it will achieve profitability;

(3) The needs of and risks to customers;

(4) The expectations of shareholders in terms of return.

The FCA expects that the Business Model threshold condition will enable it to identify risks that firms may pose in the future so that it can prevent them from being authorised where appropriate. It has stated that it will act early to reject applications from firms which it considers may pose a risk to its objectives[5].

The focus on a firm's business model and in particular on how it will generate revenue and profit will not be limited to the authorisation process. In supervision, the FCA will replace the FSA's current approach to the supervisory assessment of individual firms with its Firm Systematic Framework ("**FSF**") which will involve analysis of a firm's business model and strategy.

Firm-specific supervision will be maintained for those firms with the greatest number of retail customers or which hold the largest amount of client assets or have the biggest trading operations, i.e. the firms that the FCA considers pose the greatest risk to its objectives (which the FCA will categorise as "C1" and "C2" firms[6]). Through its firm-specific supervision, the FCA will aim to identify the risks to customers and to the integrity of markets posed by the strategy and business model of these large players and then intends to act through early intervention to prevent problems materialising.

The FCA proposes to review the whole product cycle from inception through to the end user. Providers will be challenged on the value for money of their products and on ensuring that charging structures can still ensure good outcomes for consumers. The FCA has indicated

2 Schedule 6, Paragraph 2F; 3E of the new Act (as amended) by the draft Financial Services and Markets Act 2000 (Threshold Conditions) Order.

3 CP12/34 *Regulatory Reform* - November 2012.

4 Paragraph 4.18, CP12/34 *Regulatory Reform* - November 2012.

5 Page 12, *Journey to the FCA* - October 2012.

6 The FCA will inform firms as to the category into which they have been placed in the first quarter of 2013.

The FCA's Approach to Conduct Regulation *continued from page 2*

that it will scrutinise product governance processes at firms, including how firms design, operate and sell their products. The FCA plans to assess whether products have been properly targeted and whether the needs of the target market have been taken into account in product design, whether there is sufficient product oversight and monitoring of potential outcomes for consumers, and whether distribution strategies are appropriate. The FCA's stated intention is to build on the FSA's approach and turn existing guidance on provider responsibilities[7] into rules to complement point-of-sale obligations and cover the distribution chain. Where the FCA identifies potential areas of weakness that would present a risk to its objectives, it then plans to intervene early to require firms to address those weaknesses before they are allowed to sell a new product rather than allowing sales and then sampling them after the event. This level of firm-specific supervision will be resource heavy and therefore, by necessity, will only be used for the largest firms.

Firms with fewer customers and smaller trading operations (which will be categorised as "C3" and "C4" firms) will have less day-to-day supervision. The extra resource that this will release will be used by the FCA to deal with unexpected issues (referred to in the FCA's supervision model as "Events") and to carry out analysis across industry sectors (this work is referred to in the FCA's supervision model as "Products and Issues"). Products and Issues supervision will be directed at those issues identified by the FCA's enhanced data gathering and analytical resource as positing the greatest potential risk to its objectives. By adopting an approach where less resource is assigned to individual firms, the FCA believes it will be able to identify industry and sector-wide issues that are on the horizon and intervene more effectively to stop them from escalating into major problems.

2. Intervene earlier

The FCA has said that where it identifies potential issues it will have a greater appetite for early intervention. It expects to take action more quickly than the FSA. The FCA will have new powers which are designed to enable it to deliver on its commitment to step in early to pre-empt and prevent widespread harm to consumers.

The FCA will be able to direct firms to withdraw financial promotions issued or approved (or intended to be issued or approved) by them[8]. The FCA will be able to order the immediate removal of promotions from the market or prevent them being issued in the first place if it "*considers that there has been or is likely to be a contravention of financial promotion rules*", such as, for instance, the rules as to fair, clear and not misleading communications. It will also be able to publish an explanation of its reasons for banning a promotion. The statutory procedure requires the FCA to give a written notice informing the recipient of his right to make representations to the FCA within a specified period of time. If the direction is not revoked following representations, then the recipient may refer the matter to the Upper Tribunal (established under section 3 of the Tribunals Courts and Enforcement Act 2007 and which is empowered to hear referrals of certain decisions made by the FCA). However, the FCA will publish its action in the meantime. The FCA is consulting on how this power will be exercised[9] and is proposing that the power should be exercised under executive decision-making procedures. That means that such decisions will be taken either by a senior staff committee or FSA staff members. In either case, the staff taking the decision will include at least one who was not directly involved in establishing the evidence on which the decision is based. It is anticipated by the FCA that this power will operate as a quick and effective tool separate from its enforcement powers. The FCA believes that use of the power will not only mitigate the risk of harm to consumers (by providing a quick and effective method of stopping the advertising of products), but will also benefit other firms by showing the types of promotion the FCA considers unacceptable. The FCA expects that this power will be particularly useful for new product advertisements and for promotions made through new media channels.

The FCA will also have new powers to make product intervention rules that ban the sale of particular products (or products with particular features) to all customers or to specified classes or types of customer. The FCA can make product intervention rules where it appears to the FCA that they are necessary or expedient for the purpose of advancing the consumer protection objective or the competition objective (or if the treasury make an order to that effect, the integrity objective). The rules are subject to the FCA's statutory rule making processes which include the requirement for prior consultation. However, the rules can be made on a temporary basis for a period of 12 months and without prior consultation[10] where the FCA considers

7 *Regulatory Guide: The Responsibilities of Providers and Distributors for the Fair Treatment of Customers.*

8 Financial Promotion Rules: Directions given by FCA - S137S of the new Act.

9 CP12/37: The Financial Services Bill - Implementing market powers, decision making procedures and penalties policies.

10 S137D; S137E; S138M (exemptions to consultation for temporary product intervention rules) of the new Act.

The FCA's Approach to Conduct Regulation *continued from page 3*

that it is necessary or expedient to do so in order to advance the objectives. The FCA has said that its main consideration when deciding whether to make temporary product intervention rules will be whether it deems prompt action to be necessary to seek to reduce or prevent consumer detriment arising from a product, type of product or particular practice. Since product intervention rules are made under the FCA's rule making power, any challenge to the making of the rules would lie in judicial review. Decisions to make product intervention rules, including temporary rules made without consultation, will be taken by the FCA board. When deciding whether to make such rules, the FCA will consider the competition impact that the rule may have. However, where promoting competition would be in conflict with the consumer protection or (if applicable) the integrity objective, then the consumer protection or integrity objective will take precedence over competition. The FSA has issued a consultation on a draft statement of policy[11] with respect to the FCA's use of this power. The consultation explains that the FCA will take account of the potential scale of detriment in the market and to individual customers when considering whether to exercise its powers. Temporary product intervention rules are therefore more likely to be used for widely promoted products involving a material cost or potential loss for customers. The FCA will also consider the nature of the customers affected. Where customers are vulnerable, there is a greater likelihood of action. Action will also be more likely where the market for the product is such that increased information to customers at point of sale or the impact of natural competition is unlikely to work so as to protect customers. The FCA will be required to have regard to the Regulatory Principles[12] when deciding whether to make product intervention rules and will have to consider whether the restriction placed on firms by rules which ban a product or practice is proportionate given the potential damage to customers.

The latest consultation together with an earlier FSA statement of policy[13] suggests that product intervention rules might be used in the following circumstances:

(1) Where there is an incentive for inappropriate targeting of sales of a particular product;

(2) For products with particular features that make them inappropriate for certain types of customers;

(3) For highly profitable products which are only appropriate for certain categories of customers, but which are sold more widely and where the sales force, is incentivised to deliver volume rather than quality of sale;

(4) For products sold in markets where competition is not properly effective to deliver appropriate sales, for example where competition is focused on irrelevant features;

(5) For products sold in markets where firms restrict choice or product range and accessibility in order to exploit customers. This may include markets where firms offer different customer groups different products and restrict access for no good or valid reasons;

(6) For inherently flawed products which offer such poor value or have such disadvantageous features that the majority of customers or specific customers are unlikely to benefit.

The potential consequences of breaching product intervention rules will be significant, with enforcement action likely to follow any breach. The FCA will also have the power to provide that any agreement entered into in breach of a product intervention rule will be unenforceable with money to be returned to the customer and compensation to be paid.

The FCA has said it will use these new tools in a "measured way" with an approach based on a proper understanding of the issues and a full consideration of the potential solution. However, the FCA has also indicated that it will use these powers where particularly rapid action is important in seeking to prevent or reduce the risk of customer detriment. It has said that it will be willing to act on some hard evidence rather than waiting for a comprehensive search for all possible evidence[14].

11 CP12/35 The FCA's use of temporary product intervention rules - December 2012.

12 S3B of the new Act.

13 www.fsa.gov.uk/static/pubs/other/draft-statement-policy-temporary-pi-rules.pdf.

14 Firms will need to be conscious that the context in which the FCA will be making decisions on the use of its powers is that of an organisation in which its predecessor board (the FSA board) decided that:

> *"it would have zero tolerance of absolute loss in excess of £250 million and that smaller but still significant total losses should not occur more frequently than once every five years". (Journey to the FCA, page 43)*

The FCA believes that these figures are too high and that it will expect to act in relation to issues very early if it thinks an issue has the potential to grow and cause harm. It recognises that it will need to gather data and identify risks that are quite small and gives an example of where 10,000 customers have lost £300 each. This indicates that the FCA will have a low risk threshold. This may also have significant impact for firms given the FCA's statement that:

> *"In practice, we will be more concerned about consumers—especially more vulnerable consumers who might lose money or become further indebted than about firms being able to continue in business (where the FSCS provides a safety net) except when the integrity of the market is threatened or the firm represents a prudential risk". (Journey to the FCA, page 44)*

The FCA's Approach to Conduct Regulation continued from page 4

3. Address underlying causes of problems rather than just symptoms

The FCA expects to focus its efforts on addressing the drivers of poor behaviour. It will take a particular interest in structural issues which are likely to deliver poor customer outcomes or risk market integrity. This is consistent with a greater top-down approach to regulation where large issues are addressed so as to reduce the likelihood of day-to-day risks to consumers or to the integrity of the markets materialising. Examples of issues the FCA expects to address include incentives and conflicts of interest. The FCA will aim to focus on the most significant issues so as to make the biggest impact using its limited resource. The FCA is developing a model to assess the different risks across different sectors and to prioritise the use of its supervision resource to tackle the issues given the highest priority. The FCA will flag those areas it considers high risk in its annual business plan and in its conduct risk outlook[15] documents which it will publish each year. The key questions that the FCA will ask itself when assessing and prioritising issues and product work will be:

(1) What are the cross-firm and product issues that are behind poor outcomes for consumers or endanger market integrity?

(2) What is the degree of potential harm?

(3) What is the discovery and mitigation work proposed?

The FCA anticipates that firms will experience a more intrusive approach when the FCA is addressing sector issues. Specialist supervisors will spend time reviewing files, listening to telephone recordings and commissioning mystery shopping to establish the extent of any problem. Given the FCA's new approach, firms will need to ensure that they are actively and carefully managing their interaction with the FCA when involved in issue and product work. Where the FCA identifies problems with particular firms through this work, the firm can expect early intervention, even if the FCA's work has not been completed.

4. Secure redress for consumers if failures do occur

The FCA expects to be a forward-looking regulator, but it recognises that a considerable amount of its time will still be spent dealing with problems resulting in loss to customers. Such issues will be dealt with as "Events" and the teams dealing with them are likely to include a combination of supervision and enforcement staff.

15 The Retail Conduct Risk Outlook 2012 set out the FSA's view on the 15 highest priority conduct risk areas that it believes require careful firm and regulatory focus over the 12–18 months from March 2012.

Where things have gone wrong, there will be an emphasis from the FCA on securing redress for customers. There are a number of tools the FCA will be able to use to achieve this.

At an individual firm level, the FCA (like the FSA before it) will expect firms to make voluntary offers of redress and to offer to carry out pro-active past business reviews. The willingness of a firm to take such steps will be one factor taken into account by the FCA when deciding whether it is appropriate to launch a formal investigation and/or take enforcement action against a firm or to deal with a matter through supervision. The FCA will follow the FSA's approach of requiring firms to carry out past business reviews as part of any settlement of an enforcement case (where earlier settlement will still deliver a discount in terms of fine). The FCA will also consider the approach taken by those in senior management to paying redress when assessing the fitness of a firm or its senior management.

Where firms are not prepared voluntarily to pay redress, the FCA (like the FSA before it) will have powers to require that they do so. The FCA will have the power[16] to require the payment of restitution where an authorised entity has profited from a breach of a requirement under the new Act or has caused loss to consumers as a result of a breach of a requirement, or has been involved in market abuse. The FCA can also apply to court to seek a restitution order against any person who has profited from a contravention of a requirement under the new Act or caused loss to consumers through the contravention of a requirement under the new Act[17] or as a result of having engaged in market abuse[18].

The FCA will also have tools to secure redress at a wider industry level. It will have the power[19] to require firms to undertake pro-active past business reviews. This power enables the FCA to make rules requiring such a review where the FCA believes there has been widespread or regular failure by firms to comply with requirements that apply to their regulated activity, and it appears that consumers have suffered or may suffer loss or damage in respect of which they could gain damages or a legal remedy if they brought legal proceedings. Such rules can only be made after consultation. The FSA is currently establishing the first redress scheme under this power (which existed under the old act) in relation to sales of Arch Cru funds.

16 S384 of the new Act.

17 S382 of the new Act.

18 S383 of the new Act.

19 S404 of the new Act.

The FCA's Approach to Conduct Regulation *continued from page 5*

The FCA may also follow the approach taken by the FSA and amend the rules for complaint handling to deliver customer redress in relation to particular products. The FSA has required firms, when assessing historic complaints relating to Payment Protection Insurance, to go beyond the requirements of strict compliance with the Rules and to consider the duties that the FSA considers are imposed by the Principles, even though the Principles could not provide the basis of a legal claim for damages by a customer[20].

The FCA will also have a new power of direction that it can use in relation to non-regulated holding companies[21] of certain authorised firms. The power is to direct the taking of particular action by a non-regulated holding company. The FSA Consultation on this power[22] states that the FCA may use the power to require a parent undertaking to pay redress to consumers for claims against subsidiaries arising from professional negligence or the provision of unsuitable advice.

5. Take meaningful action against firms that fail to meet standards through levels of fine that have a credible deterrence

The FCA has said that it is committed to "*bringing more enforcement cases and pressing for tough penalties for infringement of rules*"; and "*pursuing more cases against individuals and holding members of senior management accountable for their actions*". The FCA sees itself as an organisation where enforcement plays a vital role "to help make sure firms put consumers as the heart of their business and markets are sound, stable and resilient".

The FCA will inherit the current enforcement powers of the FSA. In relation to investment business, these give it the power to impose financial penalties, suspend permission and issue public censures against firms for breaches of its Rules and Principles; and to impose financial penalties, issue public censures and impose suspension or banning orders on individuals who perform controlled functions in firms. The FSA has confirmed that the FCA decisions to impose sanctions will continue to be made by its Regulatory Decisions Committee ("**RDC**"). The right to refer decisions to impose sanctions to the Upper Tribunal for independent adjudication will continue to apply.The FCA will gain additional powers to take action to help ensure the integrity of the markets. It will gain additional powers in relation to recognised investment exchanges, primary information providers and sponsors. The effect will be that the FCA will have broadly the same supervisory and sanctioning powers in relation to those entities as it currently has in relation to investment firms. The FCA will also use its investigation and enforcement powers to enforce compliance with directly applicable European regulations such as those in respect of short selling, derivative clearing and alternative investment funds. This development will bring firms that are subject to those regulations (but not the wider FCA regime) within the enforcement jurisdiction of the FCA.

The indications are that the FCA will expect to use its enforcement powers more regularly than the FSA to deliver on its objectives of market integrity and consumer protection. The FCA will also continue to seek criminal convictions for insider dealing and market manipulation and will take action against unauthorised business. The FCA will be concerned to ensure that firms have effective arrangements to prevent them being used to facilitate financial crime, and this will be a continued priority both for supervision and enforcement. The FCA focus on financial crime will include taking action against firms for inadequate anti-fraud, anti-money laundering or anti-bribery and corruption systems.

The FSA has been, and the FCA will continue to be, a very powerful investigatory organisation with wide powers to gather evidence and require individuals to answer questions truthfully and honestly and without privilege against self-incrimination[23]. It will continue to have the power to apply for a warrant to search premises.

The FCA is committed to delivering greater transparency in relation to its regulatory activities, and this drive to greater transparency is supported by the new regulatory principles which include the Principle that "*the regulators should exercise their functions as transparently as possible*[24]". In line with this principle, the new Act gives the FCA a power to publish warning notices[25] in disciplinary cases. The FCA is required to issue a warning notice when it is minded to take disciplinary action[26], but before the subject has exercised the formal right to make representations

20 The principles are FSA rules for which a right of action for a private person under S150 of the old act had been removed.

21 S192A-S192N of the new Act.

22 CP12/34 Regulatory Reform.

23 Individuals can be required to answer questions in all investigations and their answers may be used against them in proceedings except criminal offences (other than offences of misleading the regulator or perjury) and market abuse, Section 174 of the new Act.

24 S3B(1)(h) of the new Act.

25 S391 of the new Act.

26 The power to publish a warning notice is set out in S391(1ZB) of the new Act and will apply to enforcement action against individuals performing a controlled function issuers of a prospectus, sponsors issues for breaching transparency obligations, primary information providers, insurers and others in relation to listing rules, market abuse, breaches of the short-selling rules, breaches by qualifying parent undertakings of directions issued to them, discipline of authorised firms, discipline of recognised bodies, and discipline of auditors or actuaries.

The FCA's Approach to Conduct Regulation continued from page 6

in response (it will not apply to other warning notices, such as those issued when the FCA intends to reject an application for authorisation or for individual approval). Under the previous regime, the contents of warning notices were required to be kept confidential until the subject had at least had the opportunity to make substantive representations on the matter and the underlying evidence to the RDC. Confidentiality was considered important because of the damage that can be caused to a firm by adverse publicity in an industry that depends on public confidence in the honesty and reputation of firms.

The new power will enable the FCA to publish such information about the matter to which a warning notice relates as it consider appropriate having first consulted the recipient of the notice. The FCA is not required to publish the content of the warning notice unlike the position with a decision notice (the notice issued once the RDC has decided to take action after considering representations from the subject) or final notice (the notice issued once all rights of appeal have been exhausted including referral to the Upper Tribunal). However, it would be inconsistent with the FCA's aim of greater transparency if it were not to adopt an approach in favour of early publication. The new Act prohibits the FCA from publishing information about any notice if, in the opinion of the FCA, publication of the information would be:

a) Unfair to the person with respect to whom the action was taken (or was proposed to be taken);

b) Prejudicial to the interests of consumers; or

c) Detrimental to the stability of the UK financial system.

These factors will need to be argued by the recipient of the warning notice when responding to the FCA during the consultation prior to the publication of the notice. However, the final decision on publication will vest with the FCA, and the FCA, in relation to warning notices, is likely to follow the FSA's policy on the publication of decision notices where it has stated:

> *"The FSA will consider any representations made but will normally not decide against publication solely because it is claimed that publication could have a negative impact on the person's reputation[27]".*

In light of this power to publish statements about a warning notice, firms and individuals will need to ensure that they are able to identify those parts of the notice that are likely to be highly damaging to their reputation, where the evidence in support of the allegations is not strong. Warning notices are issued by the RDC after receiving proposed drafts from the enforcement team and so firms and individuals will be hoping that the RDC will be prepared to undertake a thorough review of the notice and the underlying evidence prior to issuing the notice or at least as part of the consultation process before publishing information about the notice. The FCA is consulting on the procedure that it will adopt in relation to the publication of statements about warning notices. It is proposing that a period of seven days will be given for the subject to respond to a proposal to publish a statement concerning a warning notice, but that the RDC will not normally meet with the subject in person as part of the consultation[28]. In our view, the power to publish warning notices is also likely to have the side effect of encouraging more firms to settle cases earlier, with the firm agreeing the content of the notice as part of that settlement and thereby managing publicity.

6. Conclusion

The FCA is setting itself a difficult challenge by aiming to prevent risks from crystallising. It has a very wide set of powers at its disposal and is asking its staff to use those powers based on the exercise of their judgement in cases where information may be incomplete. Its stated intention is to intervene early, but it will be wise to choose carefully those cases in which it tests the extent of its new powers and policies to avoid early and costly defeats which may well define and limit the extent of those powers. The FCA will need to be able to explain its reason and rationale for pre-emptive action because the industry will expect the principle of transparency to apply equally to the robustness of the FCA's own thought processes and internal decision making when it takes pre-emptive action as to the failures of firms when subject to its criticism. <

27 FSA Enforcement Guide, Chapter 6.

28 CP12/37: The Financial Services Bill - Implementing market powers, decision making procedures and penalties policies.

FCA Wholesale Regulation

The FCA has clearly articulated its approach to retail conduct supervision. It has also signalled an intention to be more interventionist in relation to wholesale conduct supervision.

Achieving an appropriate balance between intervention, and allowing participants in wholesale markets to manage their own relationships with each other, will be a challenge for the FCA. Wholesale market participants are generally more sophisticated and knowledgeable than retail customers. They are better equipped to understand the consequences of entering into transactions and are better able to protect and promote their own interests in the event that something goes wrong. More importantly, many of the rules that exist to protect retail customers do not apply to business between professionals.

Notwithstanding the differences between retail and wholesale business, the FCA made clear that it believes wholesale business presents a risk to its objectives and that it will need to actively manage those risks. In a recent speech, the new head of the FCA recognised that wholesale conduct encompasses a wide range of different activities and relationships. He stated that it is "*best described as a catch-all term used to describe how market participants interact with each other and conduct their business in wholesale markets, whether it is in banking, insurance or securities markets*"[1]. Wholesale conduct includes the behaviour of regulated firms and their relationships with their non-retail clients and extends to the systems and controls which govern those relationships.

The FCA has stated that its early priorities for wholesale conduct will cover three areas[2]. The first is where behaviour in a wholesale context (whether on or off market and whether in relation to banking, insurance or securities business) has or could have a knock-on effect on retail customers. An example of this would be where, for instance, a product which will ultimately be sold to retail customers is backed by assets which have been traded between market participants and where the terms of that trade are such as to result in additional, unwarranted cost for the end user. The second area is where the FCA identifies relationships between wholesale market participants of different expertise or sophistication where it feels that one warrants more protection than the other. An example could be where a non-financial customer is classified as a professional by reason of the size of its business and purchases financial products from a bank to hedge its risk in circumstances where the customer does not have the expertise to understand the nature of and effect of the product, but does not have the protection of the rules that apply to retail customers. The third area is where behaviour by or between wholesale participants brings the integrity of the market into question. The approach of firms to the setting of interest rate benchmarks such as LIBOR has been flagged as an example of such behaviour.

The FCA will continue to focus on policing and minimising market abuse, but, as indicated above, it will also adopt a wider approach to policing wholesale market conduct more generally.

WHOLESALE CONDUCT SUPERVISION

The basic approach of the FCA to wholesale conduct supervision will be the same as the overall supervisory approach to retail conduct supervision. It will comprise three elements:

- Firm-specific supervision through the application of the Firm Systematic Framework ("**FSF**");
- Unexpected or unforeseen issues ("Events"); and
- Sector or industry issues that have the potential to cause a risk to the FCA's objectives ("Products and Issues work").

These are discussed further below.

FIRM-SPECIFIC SUPERVISION

As with retail firms, wholesale firms will be grouped into four supervision categories (C1, C2, C3 and C4 — the FCA will be informing firms of which category they fall into in the first quarter of 2013). The firms will be assigned to a category depending upon their potential impact on consumers and on the integrity of the markets. C1 firms are likely to be the most complex firms with very large client assets or trading bases, whereas C4 firms are likely to be those smaller firms with simpler business models and products. The FCA recognises, however, that wholesale C3 and C4 firms could include large international banks with smaller wholesale presence in the UK.

The FSF will be broadly the same for wholesale firms as for retail firms. As with retail firms, the aim of the FSF will be to enable the FCA to assess whether the interests of consumers and market integrity are at the heart of how a firm is run. In relation to wholesale conduct, the FCA will focus in particular on the potential harm to customers and to market integrity that could arise from a failure to

1 Speech by Martin Wheatley, 20 November 2012.

2 Speech by Martin Wheatley, 20 November 2012.

FCA Wholesale Regulation *continued from page 8*

identify and manage conflicts of interest[3]. As with retail firms, the basic FSF will mainly comprise a business model and strategy analysis. The aim of the FSF will be to assess how firms manage the risks that they create and to identify the root causes of what leads to those risks. The FCA will focus on the biggest problems firms need to tackle and will prioritise actions. The FCA will put the responsibility on firms to do their own monitoring of some of the less important points and to self-attest that they have been addressed. It is likely that the FCA will use tools such as Section 166 skilled persons' reports, internal audit review and non-executive director reports as part of its approach.

For a limited number of C1 and C2 firms involved in insurance, banking and investment business, the FSF will include additional wholesale modules. These modules are likely to be applied to those firms that are most active in creating and distributing products to wholesale market participants. They are likely to involve an assessment of product design, sales and transacting, and post sales and ongoing provision of service. The FCA is still designing the modules.

Firm-specific supervision will be limited even more in relation to wholesale conduct than in relation to retail conduct. C3 and C4 wholesale firms will not be subject to regular assessment (equivalent retail firms will be subject to some form of regular assessment on a four-year cycle).

The majority of wholesale conduct supervision will be focused on Events and Products and Issues.

EVENTS

Event-driven supervision work will focus on addressing the consequences of previously unforeseen issues. The FCA will have a greater appetite for addressing events which occur between wholesale firms and their customers or on wholesale markets. However, the FCA will decide the extent to which it will become involved in an event by reference to the risk to its objectives. It will consider the extent to which consumers have been or are likely to be damaged, the nature and sophistication of those consumers, and the extent to which the integrity of the market may be at risk. It is likely that in many cases, the FCA will choose to allow professional market participants to deal with issues between them through negotiation or by reverting to the law. However, if the FCA considers that the event may indicate that a firm's activities undermine the integrity of the market or could damage a number of more vulnerable professional customers, then it is more likely to take action.

Event-driven work is likely to be prompted by the FCA becoming aware of particular issues through its information gathering activity or, more likely, through self-reporting by firms (as required by the rules). Given the greater intensity of the FCA in wholesale conduct supervision, when a firm becomes aware of a reportable event, it will need to take care to present a solution to the FCA. The FCA will be looking for firms to act in a proactive fashion when they have identified a problem or issue as this will evidence that they have the interests of consumers and integrity of the markets at the heart of their business.

Wholesale firms may find (as retail firms have found in the past) that reliance on strict legal rights and obligations between contracting parties and adherence to the precise requirements of relevant rules are no longer sufficient to satisfy the regulator. The FCA will expect firms to adhere to the spirit as well as the letter of the law and, to the extent that there is evidence that they have not done so, for firms to take appropriate action.

Enhanced protection for professional customers is likely to be an area of contention between the FCA and wholesale firms. Many of the principles for business, which have been relied on by the FSA in the past in order to extend the obligations of the precise Conduct of Business Rules in relation to transactions with retail customers, will not always apply to business conducted with professionals. However, Principle 1 (integrity) and Principle 2 (due skill care and diligence) apply to business conducted between professionals as well as to that conducted with retail customers. These may enable the FCA to require action where abusive behaviour or activity is identified, notwithstanding the fact that the firm may have complied with the precise Conduct of Business Rules or requirements which apply when dealing with a professional. Given the more intrusive approach of the regulator, firms will be wise to redouble their efforts to prevent the creation of embarrassing and damaging messages passing between staff which may suggest that professional customers have been exploited for the benefit of the firm.

PRODUCTS AND ISSUES

Wholesale C3 and C4 firms will be supervised mainly through Products and Issues work. Products and Issues work may be commissioned following a piece of event-driven supervision. In the "Journey to the FCA" document, an example is given of Products and Issues work following an FCA enquiry into suggestions that a wholesale market participant has made additional income through misrepresenting the price at which individual trades are

3 Page 32, *Journey to the FCA* - October 2012.

FCA Wholesale Regulation *continued from page 9*

executed to a professional client during the restructure of a portfolio. The FCA suggests that one response to this would be a wider sample review within the industry to test whether the practice is widespread. This could then be followed by the potential introduction of new rules and the launch of enforcement action against the worst offenders.

CONCLUSION ON WHOLESALE CONDUCT SUPERVISION

The impact of the new approach to wholesale conduct supervision is still a matter of conjecture, but it is already clear that it will be felt in a number of ways. A number of firms are likely to have far less day-to-day interaction with the FCA than they previously had with the FSA. This is because of the focus of firm-specific supervision on only the biggest and highest impact firms. Firms will, however, be likely to find that the FCA is more interested in complaints made by wholesale market participants against each other and by professionals, as these will form a valuable source of information for FCA about what is happening in the market. The FCA expects to adopt a more intrusive approach in assessing the root cause of issues it identifies and expects to act more quickly at both a firmwide and industry-wide level. It has signalled its intent to test the narrow interpretation of the precise rules which govern business with professionals against the wider obligations imposed by the principles and its expectation that firms will have the interests of consumers and the integrity of markets at their heart. When dealing with disputes with professional customers and with market participants, firms will need to give thought to how an approach that relies on strict legal interpretation of applicable rules might be viewed by the regulator and what the potential regulatory consequences of such an approach might be irrespective of whether it may be successful in litigation. <

Contentious Regulatory Law 2012: Key FSA Enforcement Action

Throughout 2012, the FSA has continued its credible deterrence approach, with its emphasis in the retail area on consumer outcomes and concerns around suitability evident in some of the most significant cases. The FSA has also been active in using its enforcement powers in relation to activity by wholesale market participants. Along with other overseas regulators, the FSA has been active in the LIBOR investigation which has shone a spotlight on behaviour by wholesale market participants. Final notices have been issued to UBS (imposing a fine of £160 million) and Barclays (imposing a fine of £59 million) anticipated to be amongst the first of several actions taken against banks in this area. Unsurprisingly, given this background, the FCA has made clear that it intends to be more active in its supervision of and intervention in wholesale markets and behaviour. The FSA has demonstrated a continued appetite for market abuse cases against firms and high-profile, senior individuals, and the FCA is likely to take a similar robust approach against high-profile individuals to achieve maximum impact amongst the regulated community.

Scrutiny continues to be given to the roles of senior management, with action taken against CEOs as well as compliance officers. The FSA issued a final notice imposing a fine of £500,000 and a partial prohibition to Peter Cummings, the ex CEO of the HBOS Corporate Division, but was unsuccessful in its case against John Pottage, the CEO of UBS's wealth management division. The Upper Tribunal rejected the FSA's case, saying that there was insufficient evidence to prove the allegation that Mr Pottage had failed to take reasonable steps to ensure that the business of the firm complied with the requirements and standards of the regulatory system. The case demonstrates the value of referring a Decision Notice to the Upper Tribunal, as it should not be assumed that the FSA's analysis will always be accepted.

The year also showed, however, that a referral to the Upper Tribunal also carries the risk that the Upper Tribunal may expand the case against the applicant and/or increase the penalty imposed by the FSA. Patrick Sejean referred the Decision Notice he received from the FSA imposing a fine of £550,000 for market abuse to the Upper Tribunal. The Upper Tribunal allowed the FSA to include in its case an additional, related allegation that had not been present in the FSA's Decision Notice. Having found Mr Sejean guilty of the additional allegation (as well as the allegations included in the Decision Notice), it increased his fine by £100,000. Given the Upper Tribunal's wide discretion to include additional (albeit related) issues and increase fines, any decision to refer requires careful analysis of the risks of doing so, as well as the potential reward.

Contentious Regulatory Law 2012 *continued from page 10*

LIBOR

On 19 December 2012, the FSA issued a Final Notice to UBS AG (**"UBS"**) imposing its largest fine to date of £160 million[1] for misconduct relating to the London Inter-Bank Offered Rate (**"LIBOR"**) and Euro Inter Bank Offered Rate (**"EURIBOR"**). UBS also agreed to pay fines of £740 million to the US regulators and £40 million to the Swiss regulator[2]. UBS's breaches encompassed a number of issues and continued from 1 January 2005 to 31 December 2010. The breaches included: traders routinely making requests to the individuals responsible for LIBOR and EURIBOR submissions to adjust their submissions to benefit their trading positions; giving the roles of determining the LIBOR and EURIBOR submissions to traders whose positions made a profit or loss depending where the rates fixed (an inherent conflict of interest); colluding with interdealer brokers in coordinated attempts to influence Japanese Yen submissions made by other panel banks (additional brokerage payments were made to reward brokers for this); colluding with individuals at other panel banks to get them to make Japanese Yen LIBOR submissions that benefited UBS's trading positions; and adopting LIBOR submissions directives whose primary purpose was to protect the bank's reputation by avoiding negative media attention about its submissions and speculation about its creditworthiness[3].

At least 2,000 requests for inappropriate submissions were documented. Manipulation of the rates was openly discussed in internal chat forums and group emails. At least 45 individuals, including traders, managers and senior managers, were involved in or were aware of the practice of attempting to influence submissions[4]. The manipulation of the submissions was not detected by UBS Compliance or its group internal audit, despite five audits being undertaken of the relevant business area, over the period. The fine imposed on UBS was significantly higher than that imposed on Barclays on 27 June 2012[5].

Barclays has been fined £59.5 million (discounted from £85 million for early settlement) for misconduct in relation to Barclays' rate setting for LIBOR and EURIBOR. This was coupled with fines imposed in the United States. Barclays' failings related not only to its rate setters taking into account requests from its derivative traders to adjust the rates to benefit their trading positions, but also the suggestion that Barclays had adjusted its rate submission so as to avoid negative media commentary about its financial position at the peak of the financial crisis. Barclays' compliance and systems and controls in this area were also criticised.

Martin Wheatley, CEO designate of the FCA, conducted a review into LIBOR[6] and concluded that it should be reformed rather than replaced. The government has accepted the recommendations of the Wheatley review, and legislation will implement the recommendations[7].

The new Financial Service Act amendments will:

- Bring LIBOR activities within the scope of statutory regulation, including the submission and administration of LIBOR;
- Create a new criminal offence for misleading statements in relation to benchmarks, such as LIBOR, as well as amending the language of existing offences; and
- Give the FCA specific power to make rules requiring banks to submit to LIBOR, with reference to a code of practice produced by the rate administrator.

Market participants will continue to play a significant role in the production and oversight of LIBOR. It was not considered appropriate for the authorities to take over the process of producing a benchmark which exists primarily for the benefit of market participants.

The FSA has not ruled out action against individuals with regard to LIBOR failings, but it may take some time before such proceedings crystallise.

The implications for banks coming out of the LIBOR scandal could extend beyond regulatory fines. The High Court recently agreed that Guardian Care Homes could pursue its case against Barclays, in which it alleges that its losses of £12 million were the result of the manipulation of LIBOR. It will be the first LIBOR damages trial in the United Kingdom and will be closely watched as a test case for potential future claims against other banks in this area.

MARKET ABUSE AND INSIDER TRADING

The FSA has continued aggressively to pursue cases of market abuse and insider dealing, with key cases emerging in both the civil and criminal jurisdictions.

Nicholas Kyprios[8] (head of credit sales at Credit Suisse Securities (Europe) Limited (**"Credit Suisse"**)) was fined £210,000 (discounted from £300,000 to reflect early settlement) for disclosing information to a potential investor that was confidential to Credit Suisse's client

1 Discounted for early settlement. The fine would otherwise have been £200 million.

2 UBS press release 19 December 2012.

3 FSA Press release 19 December 2012.

4 FSA Press release 19 December 2012.

5 Final Notice 27 June 2012.

6 *The Wheatley Review*, issued in September 2012.

7 HM Treasury: *Implementing the Wheatley Review*: draft secondary legislation, November 2012.

8 Final Notice 13 March 2012.

Contentious Regulatory Law 2012 *continued from page 11*

Liberty Global, Inc ("**Liberty**"). Mr Kyprios disclosed information that had been treated as inside information by his firm, and that he did not have Liberty's permission to disclose.

The information related to a potential multibillion-euro bond issue[9] ("**the information**"). The information was not price sensitive in relation to qualifying investments[10], but was price sensitive in respect of outstanding floating rate notes[11] and credit default swaps[12]. Credit Suisse had prohibited Mr Kyprios from discussing the information with anyone outside Credit Suisse and told him it was inside information. Nonetheless, Mr Kyprios signalled certain aspects of the information to a fund manager who was a potential investor, despite the fact the fund manager had asked not to be wall crossed[13].

Although the FSA accepted that the information disclosed by Mr Kyprios was not "inside information" as defined in s.118C of FSMA, Mr Kyprios was considered to have failed to observe the proper standards of market conduct. This approach is evidence of the FSA's determination not to be bound by the technicalities of the legislation on market abuse when dealing with what it perceives to be unacceptable behaviour by those within the regulated community. Mr Kyprios sought to disclose the information indirectly by playing guessing games, for example, asking the potential investor to guess the correct issuer in a game of "getting warmer". The FSA considered that the content and meaning of the calls was clear and did not accept Mr Kyprios's explanation that the conversation was merely banter. As this case was settled, the FSA's analysis was not tested before the Upper Tribunal.

The FSA's case against Ian Hannam[14] (who at the time of events was the global co-head of UK Capital Markets at J P Morgan[15]) concerned "non-deliberate" market abuse. The FSA says that Mr Hannam disclosed inside information to contacts in relation to Heritage Oil Plc ("**Heritage**"). Heritage was an existing J P Morgan client for which Mr Hannam was the lead adviser. The information is said to have been disclosed in two emails, one containing information about a potential offer for Heritage and the second (in which Mr Hannam said "*Tony has just found oil and it is looking good*") conveying information oil had been found. The FSA considered that Mr Hannam had committed a serious error of judgement in disclosing the information.

Mr Hannam's arguments included the assertion that the FSA should have applied the criminal standard of proof, that the information conveyed was insufficiently precise and price sensitive to constitute inside information, and that information contained in the first email had already been disclosed to the party Mr Hannam was communicating with (and so he was already aware of the information). Mr Hannam also said that the FSA was taking his communications out of context, he was either acting in the proper course of the exercise of his employment, profession and duties[16] because he was acting to further the interests of his client Heritage Oil, or he had believed he was acting in the proper course of the exercise of his employment, profession and duties and therefore believed on reasonable grounds that he had not committed market abuse[17]. The FSA rejected these arguments and imposed a financial penalty of £450,000. It considered that this was an appropriate penalty given Mr Hannam's seniority, experience, level of influence within JP Morgan and the need for credible deterrence of such behaviour.

Mr Hannam has referred the Decision Notice to the Upper Tribunal, with the hearing expected to take place in July 2013.

The FSA has successfully pursued other enforcement actions against firms and individuals who have unknowingly received and traded upon the basis of inside information. In those cases, the FSA has argued that market participants must have robust systems in place to identify inside information and to treat it accordingly (even where, for example, the firm has specifically requested that it not be provided with inside information (i.e. "wall-crossing")).

In September 2012, the Upper Tribunal issued its judgment[18] on the referrals by Stefan Chaligné, Patrick Sejean and Tidiane Diallo of the FSA's decision to fine Mr Chaligné and Mr Sejean and impose full prohibitions on all three for market abuse[19]. Mr Chaligné, a Swiss-based fund

9 Liberty agreed to acquire Unitymedia GmbH ("Unitymedia"). Liberty appointed Credit Suisse as lead book runner for the potential bond issue, the proceeds of which were likely to be used in part to finance Liberty's acquisition of Unitymedia, and in part to refinance outstanding listed Unitymedia bonds in a complex transaction. Although the bond was initially to be issued by a different subsidiary of Liberty, it was referenced on the assets of Unitymedia, to be pushed down to Unitymedia upon issuance and publicly marketed as a Unitymedia bond.

10 As would be required under the definition of 'inside information' in s118C of FSMA 2000.

11 Unitymedia floating rate notes.

12 Unitymedia credit default swaps.

13 Mr Kyprios also contacted a second fund manager (who had not been wall crossed) and disclosed information about the potential issuer, using hints and word play. The second fund manager is not described in the final notice as being a potential investor.

14 Decision Notice 27 February 2012.

15 J.P. Morgan Cazenove Limited.

16 S118(3) FSA includes disclosing inside information to another person otherwise than in the proper course of the exercise of his employment, profession or duties as a behaviour that constitutes market abuse.

17 S123(2) FSMA defence to the FSA imposing a fine for market abuse.

18 *Stefan Chaligné, Patrick Sejean, Cheickh Tidiane Diallo v The FSA* (Upper Tribunal FS/2011/0001, FS/2011/0002, FS/2011/0003 28 September 2012).

19 The FSA fined Mr Chaligné £900,000, required him to disgorge his financial benefit of £266,924 and prohibited him from working in financial services. Mr Sejean was also given a full prohibition, and the FSA imposed a financial penalty of £550,000. Mr Diallo was given a full prohibition and would have been fined £100,000 but for his financial hardship.

Contentious Regulatory Law 2012 *continued from page 12*

manager, was both the fund manager and a shareholder in a Cayman Islands-based hedge fund. He was said to have deliberately manipulated the market in a number of securities by placing orders through a broker which were designed to increase the closing price of the securities. This increased the value of the hedge fund on two key portfolio valuation dates (a practice known as "window dressing the close"). Mr Sejean and Mr Diallo assisted Mr Chaligné by effecting and executing his orders, despite knowing these were manipulative in nature.

The Upper Tribunal upheld the penalty and prohibition imposed on Mr Chaligné and the prohibition imposed on Mr Diallo. Interestingly, although the FSA's Regulatory Decisions Committee (**"RDC"**) chose not to include an additional (related) allegation of market abuse by Mr Sejean, the Upper Tribunal made it clear that it had the jurisdiction to consider all relevant material and was not restricted by the RDC's view of it. The Upper Tribunal allowed the FSA to include the additional allegation and, having found it proved, increased the penalty imposed on Mr Sejean from £550,000 to £650,000. The case is a useful reminder that the Upper Tribunal has a wide jurisdiction (albeit its enquiry must be limited to facts and events connected with the subject matter of a referred decision notice), and, although rare, it can choose to increase a financial penalty from that imposed in a Decision Notice[20].

The FSA secured criminal convictions against six individuals[21] involved in a complex and sophisticated insider dealing ring. The defendants obtained confidential and price-sensitive information from investment banks concerning proposed or forthcoming takeover bids. They then used a large number of accounts to place spread bets ahead of the announcements knowing that when the information became public, the price would rise. It was an attempt to deal on inside information over a long period and involved one of the most intensive and long-running FSA investigations to date.

ANTI-MONEY LAUNDERING

Following the publication of its thematic review in June 2011, the FSA has taken a number of cases against firms for anti-money laundering (**"AML"**) failings. The cases have involved a variety of firms, with significant fines imposed.

20 Mr Sejean made a serious financial hardship application which was rejected by the Tribunal. The Tribunal confirmed that serious financial hardship applications should only succeed where there was clear evidence of excessive hardship. In this case, it found that Mr Sejean's disclosure in relation to his finances was partial and incomplete and could not be satisfied that Mr Sejean had provided a complete and wholly truthful account of his assets and liabilities and in consequence would not be satisfied that he had established hardship.

21 Ali Mustafa, Pardip Saini, Paresh Shah were sentenced to three years and six months; Neten Shah was sentenced to 18 months; Bijal Shah and Truptesh Patel were both sentenced to two years.

The cases signal how seriously the FSA takes failings in this area, and this is an approach likely to be continued under the FCA. The FSA has taken action against firms as well as individuals and has emphasised that firms must be vigilant when dealing with jurisdictions that do not have UK-equivalent AML controls.

Coutts & Company[22] received a financial penalty of £8.75 million (reduced from £12.5 million for early settlement) for failing to establish and maintain effective AML systems and controls in relation to customers that posed a higher money laundering risk. Coutts' misconduct was viewed as especially serious as it occurred at a time when Coutts was expanding its customer base and targeting customers from jurisdictions where the AML requirements were not equivalent to those in the United Kingdom.

Habib Bank AG Zurich[23] (**"Habib"**) was fined £525,000 (reduced from £750,000 for early settlement) for AML systems and control failures covering a period of nearly three years. Habib's misconduct included failing to establish and maintain an adequate procedure for assessing the level of money laundering risk posed by prospective and existing customers, failing to conduct sufficient enhanced due diligence in relation to higher risk customers, and failing to carry out adequate reviews of its AML systems and controls and revise its training to address shortcomings identified in AML practice. Approximately 45 per cent of Habib's customers were based outside the United Kingdom, and these customers accounted for 70 per cent of its deposits. Around a third of these customers (representing approximately 50 per cent of Habib's deposits) came from jurisdictions which carried a higher risk of money laundering[24], and, as such, Habib's weakness in its AML procedures was viewed as particularly serious. Habib's policy of excluding Pakistan and Kenya from its high-risk country list was considered by the FSA to be "seriously misconceived" given the higher risk of money laundering they presented[25]. This risk was not negated by Habib's physical presence in these countries or any specialist knowledge of them. When Habib added Pakistan and Kenya to its high-risk country list in November 2010 (following the recommendation of a skilled person appointed under s166 of FSMA), it resulted in the reclassification of 170 accounts from normal to higher risk. The FSA also fined Habib's Money Laundering Reporting Officer[26] £17,500 after discount for early settlement.

22 Final Notice 23 March 2012.

23 Final Notice 4 May 2012.

24 Countries that do not have AML requirements equivalent to those in the UK and/or carry a higher risk of money laundering because they are perceived to have greater levels of are seen as at higher risk of money laundering.

25 Both Kenya and Pakistan are considered to be higher risk jurisdictions.

26 Syed Itrat Hussain Final Notice 4 May 2012.

Contentious Regulatory Law 2012 continued from page 13

The FSA imposed a fine of £294,000 (reduced from £420,000 for early settlement) on Turkish Bank (UK) Ltd[27] ("**TBUK**") for widespread anti-money laundering failings in relation to its correspondent banking activities. This is the first case in which the FSA has taken enforcement action against a firm in relation to money laundering weaknesses in its correspondent banking activities.

Correspondent banking is considered to pose a higher risk of money laundering because it is not "face-to-face" business. Correspondents often do not have a relationship with the underlying parties to a transaction (and therefore are unable to verify their identities) and often have little information about the nature or purpose of the underlying transactions[28]. As such, the FSA considers that extra vigilance is required. TBUK acted as agent for respondents in Turkey and Northern Cyprus, providing its respondents' underlying customers with services that those respondents could not provide themselves. TBUK relied on its respondents' AML controls over their underlying customers. The FSA found this was insufficient because Turkey was not a jurisdiction with UK-equivalent AML requirements at the relevant time and Northern Cyprus had not been assessed as having UK-equivalent AML requirements. Despite FSA supervisors warning TBUK in 2007 that it had deficiencies in its money laundering controls, TBUK still failed sufficiently to address these.

The cases reinforce the risk to banks of failing to apply rigorous due diligence and risk monitoring to customers in relation to AML. In its thematic review findings, the FSA noted that:

> *"Some banks appeared unwilling to turn away or exit very profitable business relationships when there appeared to be an unacceptable risk of handling the proceeds of crime. Around a third of banks appeared willing to accept very high levels of money laundering risk if the immediate reputational and regulatory risk was acceptable[29]".*

The recent cases have made it clear that such an approach is unacceptable to the FSA, which will take enforcement action if required.

The FSA has also worked with overseas authorities in relation to AML requirements. HSBC Group plc agreed to pay fines of US$1.9 billion (£1.19 billion) to US authorities for money laundering failings[30]. The FSA imposed requirements on HSBC Holdings plc to ensure that all parts of the HSBC Group were in compliance with regulatory requirements across the group to prevent similar failings occurring in the future[31].

CASS BREACHES/CLIENT MONEY

The FSA continues its pursuit of firms with regard to client money failings. BlackRock Investment Management (UK) Limited ("**BIM**") was fined £9,533,100 (reduced from £13,618,800 for early settlement) for breaches of client money requirements and failings in its systems and controls[32]. BIM did not comply with the requirement to provide appropriate notification and obtain trust letters from institutions in relation to a number of its client money market deposits in the period between 1 October 2006 and 31 March 2010. BIM's breaches arose after a series of organisational and system changes which took place following its acquisition by BlackRock group in September 2006. The FSA said that the changes resulted in a weakening of the client money oversight and compliance arrangements and the departure of certain members of staff with institutional knowledge contributed to the firm's delay in identifying and addressing the issues. As part of its investigation, the FSA contacted four of the counterparty banks with whom BIM placed the majority of money market deposits over the relevant period and with whom it did not have trust letters in place. The majority of these banks confirmed that they had thought BIM was the legal owner of the deposits and they were not aware that they were holding client money. The FSA considered that in the event of insolvency, clients would have suffered delay in securing the return of their funds and may not have recovered their money in full. The case is a warning to firms that they must ensure that there is continuity of oversight and compliance in these areas as, if left unmonitored, breaches could go unnoticed for an extended period of time.

UCIS (UNREGULATED COLLECTIVE INVESTMENT SCHEMES)

UCIS are collective investment schemes which do not satisfy the criteria to be regulated collective investment schemes[33]. Although the schemes themselves are not regulated, those individuals that carry on regulated activity in relation to them will fall within the FSA's jurisdiction.

UCIS investments typically aim to generate high returns, but have a number of additional risks which an adviser should consider when deciding whether to recommend them to a customer. Depending on the structure of the

27 Final Notice 26 July 2012.

28 Banks Management of High Money Laundering Risk Situations, FSA June 2011 (para 151).

29 Banks' management of High Money Laundering Risk Situations, FSA June 2011 (para 7).

30 Press reports Guardian, BBC News, Reuters 11 December 2012, HSBC press release 11 December 2012.

31 FSA Press release 11 December 2012.

32 Final Notice 11 September 2012.

33 See Part XVII of FSMA and COLL.

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scheme, the management and protection of its assets may not be covered by the Financial Ombudsman Service ("**FOS**") or the Financial Services Compensation Scheme ("**FSCS**"), although customers can pursue FOS claims against the investment advisers where they have breached their obligations in relation to advice or promotion of the scheme. The FSA has published proposals[34] to ban the promotion of UCIS and similar products (together known as "non-mainstream pooled investments") to the majority of retail customers in the United Kingdom[35]. The proposed rules will only allow promotion of non-mainstream pooled investments to sophisticated investors and high net-worth individuals for whom the products are more likely to be suitable.

The FSA has taken robust enforcement action against firms that have recommended and sold UCIS in breach of the regulatory requirements. IFA firm Topps Rogers Management Limited was fined £97,600 for failing to promote UCIS in accordance with regulatory and statutory requirements or ensure the suitability of its recommendations[36]. Enforcement action was also taken against two directors of MNFA Limited ("**MNFA**") who were involved in promoting a UCIS scheme known as the Environmentally Beneficial Plant Scheme ("**EBP Scheme**"). The UCIS was sold to customers in breach of regulatory requirements and without adequate compliance monitoring. Customers invested around £11.6 million in the EBP Scheme that was unlawfully promoted, and the majority of investors subsequently sustained substantial losses. Anthony Adams, who was a director and MNFA's compliance officer, was prohibited from holding roles as an SIF other than as or through an appointed representative[37]. Richard Rhys, who was a director and the leading approved person promoting and marketing the EBP Scheme, was given a full prohibition.

MIS-SELLING

A topic of significant media comment has been the mis-selling of interest hedging products to certain small and medium businesses ("**SME**"). The FSA's approach in this area shows its continued commitment to securing redress, sometimes alongside and sometimes instead of enforcement action. From 2001 to date, banks are believed to have sold around 28,000 of these products to customers. The FSA conducted a review of these sales in 2012 and found a range of poor sales practices that included poor disclosure of exit costs, failing to ascertain customers' understanding of risk, non-advised sales straying into advice, over-hedging, and sales and incentives being a driver of these practices. The FSA has reached agreements with a number of banks, including Barclays, HSBC, Lloyds and RBS, that they will provide appropriate redress where mis-selling of interest rate hedging products has occurred. The banks have also agreed to stop marketing interest rate structured collars to retail customers.

The FSA fined Savoy Investment Management Limited ("**Savoy**") £412,000 (after discount for early settlement) for failing to take reasonable care to ensure the suitability of the investment portfolios of its wealth-management clients[38]. Investment managers were allowed significant discretion in advising clients, and Savoy's controls and processes were not sufficient to ensure the suitability of that advice and portfolio management. Files lacked information on the clients' personal and financial circumstances and contained out-of-date and inadequate client information. The FSA considered that clients were therefore at risk of having investment decisions made that did not match their expectations and attitude to risk. The FSA reviewed Savoy as part of its thematic review of the wealth-management sector, and we can expect further enforcement action in this area.

SYSTEMS AND CONTROLS

The FSA issued a public censure to Bank of Scotland[39] ("**HBOS**") as a result of the failings of the firm in relation to its corporate banking division ("**Corporate**") throughout 2006 and 2008. The FSA was critical of corporate pursuing an aggressive growth strategy between January 2006 and March 2008, despite what were said to be "known weaknesses" in the control framework. Although the FSA accepted that the firm had initiated a number of projects designed to improve the control framework and that the severe financial crisis and economic downturn in the course of the relevant period was not reasonably foreseeable, it still found that the firm's standard of conduct fell below what was reasonable in the circumstances. No fine was imposed because of what the FSA described as "*the exceptional circumstances of the case*". It found that the misconduct had contributed to the circumstances in which public money had been used to acquire 43 per cent of Lloyds Banking Group following its takeover of HBOS. The FSA considered that a fine which would impact the taxpayer would therefore be inappropriate.

34 Consultation Paper 12/19 (Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes).

35 Its thematic work in this area has found that current restrictions on the promotion of Unregulated Collective Investment Schemes are poorly understood or are ignored and that many products that exhibit similar risks are structured in a way to avoid the restriction.

36 Final Notice 13 February 2012. The sole partner and adviser at the firm, Martin Rigney was fined £117,330 and given a full prohibition.

37 Final Notice Anthony Adams 21 February 2012, Final Notice Richard Rhys 27 July 2012.

38 Final Notice 13 November 2012.

39 Final Notice 9 March 2012.

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The FSA did, however, impose a fine on the CEO of the corporate division, Peter Cummings[40]. The FSA imposed a financial penalty of £500,000 on Mr Cummings for failing to act with due skill, care and diligence as an "Approved Person" and for being knowingly concerned in the contraventions by HBOS. This is the highest fine to date imposed on a senior executive for management failings. Mr Cummings was also prohibited from performing any significant influence function in any authorised firm that was a bank, building society or banking-related firm. Mr Cummings made his views about the FSA process and outcome known when he appeared before the sub-committee of the Parliamentary Commission on Banking Standards on 14 December 2012. He described the FSA's action as "*unfair and a bit sinister*" and explained that he had chosen not to fight the case further because of this health and the potential expense of doing so. He also revealed that the fine had been reduced by the FSA in the course of a meeting and two phone calls from £800,000 to £500,000 on the condition Mr Cummings did not appeal.

In contrast to the result achieved against Mr Cummings, the FSA was unsuccessful in its case alleging management failings against John Pottage, the CEO of UBS's wealth-management business who did take his case to the Upper Tribunal. The case against Mr Pottage was viewed by many as something of a test case for the FSA in pursuing a SIF holder in relation to alleged failures in oversight and supervision of the business for which he was responsible. The FSA alleged that Mr Pottage had failed to take reasonable steps to identify or remediate flaws in the governance and risk management frameworks and ensure that the firm complied with regulatory requirements. Mr Pottage was also criticised for failing to initiate a "comprehensive bottom-up review of systems and controls across the whole business sooner than he did". Although Mr Pottage had taken steps to identify deficiencies in the framework and investigate compliance issues that arose, the FSA considered that he had not taken sufficient account of warning signals within the business and, as a result, failed to make himself aware of shortcomings in the firm's systems and controls as quickly as he should have. It sought to impose a fine of £100,000. The Upper Tribunal held that the FSA's allegations were not supported by the evidence, saying:

> *"Put positively, we think that the actions that Mr Pottage in fact took prior to July 2007 to deal with the operational and compliance issues as they arose were reasonable steps".*

40 Final Notice 12 September 2012.

On 25 November 2012, the FSA imposed a fine of £29.7 million (after discount for early settlement) on UBS AG on for failures in its systems and controls in its Global Synthetic Equities (**"GSE"**) business conducted from its London branch. These breaches became apparent when UBS discovered that its trader Kweko Adeboli had amassed losses of £2.3 billion through his trades on the exchange-traded funds desk in the GSE division. The fine imposed was calculated under the FSA's 2010 penalties framework, based on revenues on the GSE desk over a 12-month period. The FSA noted its expectation that firms should give consideration to whether systems and controls deficiencies identified in an enforcement action (in this case, that taken against UBS in 2009) are applicable to other business areas within the same branch and whether remedial action is necessary.

Significant fines were also imposed on firms relating to failures in systems and controls around discretionary management of unlisted investments, as well as serious failures in corporate governance and controls following a decision to expand and diversify into a new business area.

CONCLUSION

The cases throughout the course of 2012 have shown the FSA's continued appetite for robust enforcement action. It has demonstrated its increasing confidence as a regulator, pursuing difficult cases against senior individuals, accepting that it will not always succeed. Those facing enforcement action must carefully analyse the merits of their case to decide whether to settle or defend their position. It should not be assumed that the Upper Tribunal will agree with the regulator's characterisation of a case, but equally, on rare occasions, the Upper Tribunal may impose a harsher penalty than that imposed in a Decision Notice.

Recent cases have also foreshadowed the approach that is anticipated under the FCA. We can expect the FCA to focus its resources on the cases it believes will make greatest impact on the regulatory community. It is likely that the FCA will pursue cases that send strong messages to the market and on breaches by high profile individuals. The agreement reached between the FSA and certain banks with regard to interest rate swaps and customer redress illustrates a pragmatic approach that achieved a swift outcome, without the necessity for immediate enforcement action. It is likely that the FCA will strive to achieve similar outcomes in the future, and firms will need to be prepared to be proactive in making plans to address identified issues when reporting matters to the FCA. Such an approach will mitigate the risk of enforcement activity and will demonstrate to the FCA that a firm does have customer interests at the heart of its strategy. <

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